

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
BRIEF**

75-7291

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In The
UNITED STATES COURT OF APPEALS
For the Second Circuit

Docket No. 75-7291

S.E. STEIN, as Trustee in Bankruptcy
for the Estate of Seaway Floor and
Paving Co., Inc.,

Plaintiff-Appellee,

-against-

RAND CONSTRUCTION COMPANY, INC.,

Defendant-Appellant.

On Appeal from the United States District
Court for the Southern District of New York

APPELLANT'S BRIEF

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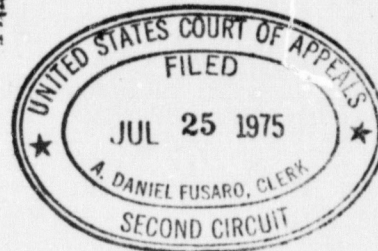


TABLE OF CONTENTS

	<u>Page</u>
PRELIMINARY STATEMENT.....	1
ISSUES PRESENTED FOR REVIEW.....	4
FACTUAL STATEMENT.....	4
POINT I: THE CERTIFICATE OF DEPOSIT WAS HELD BY THE ESCROW AGENT FOR RAND'S BENE- FIT FROM ON OR ABOUT APRIL 7, 1967, THEREBY PERFECTING RAND'S INTEREST IN SUCH PROPERTY WELL IN ADVANCE OF THE FOUR MONTH PERIOD IMMEDIATELY PRECEDING THE FILING OF SEAWAY'S PETITION IN BANKRUPTCY.....	11
POINT II: IF THE TRANSFER OF OR PERFECTION OF RAND'S INTEREST IN THE CERTIFICATE OF DEPOSIT IN REFERENCE IS NOT DEEMED TO HAVE OCCURRED ON APRIL 7, 1967, THEN IT SHOULD BE HELD TO HAVE OCCURRED ON OCTOBER 26, 1967, SEVERAL DAYS PRIOR TO THE FOUR MONTH STATUTORY PERIOD.....	21
POINT III: EVEN IF RAND SHOULD BE FOUND NOT TO HAVE PERFECTED ITS SECURITY INTEREST IN THE CERTIFICATE OF DEPOSIT ON APRIL 7, 1967 OR OCTOBER 26, 1967, RAND WAS ENTITLED TO AN EQUITABLE LIEN THEREIN AT THAT TIME WHICH SHOULD BE GIVEN EFFECT.....	26
POINT IV: RAND RECEIVED NO FUNDS FROM THE DEBTOR'S PROPERTY AND ACCORDINGLY SHOULD NOT BE DEEMED TO HAVE RE- CEIVED A PREFERENCE.....	31
POINT V: RAND DID NOT HAVE REASONABLE CAUSE TO BELIEVE THAT SEAWAY WAS INSOL- VENT AT THE TIME OF THE TRANSFER OF THE DEBTOR'S PROPERTY.....	34

TABLE OF CONTENTS (Cont'd.)

	<u>Page</u>
CONCLUSION.....	38
ADDENDUM.....	39

TABLE OF CASES AND AUTHORITIES

<u>Cases</u>	<u>Page</u>
<u>Barney v. Rigby Loan & Investment Co.</u> 344 F.Supp. 694 (D.Idaho 1972).....	17
<u>Brinig v. American Credit Bureau, Inc.</u> 439 F.2d 43 (9th Cir. 1971).....	32, 33
<u>Carson v. Federal Reserve Bank of New York</u> 254 N.Y. 218, 172 N.E. 475 (1930).....	3
<u>In re Copeland</u> 391 F.Supp. 134 (D.Del. 1975).....	17, 18, 23
<u>Danielson v. Joint Board of Coat, Suit, and Allied Garment Workers Union</u> 494 F.2d 1230 (2d Cir. 1974).....	37
<u>In re Dolly Madison Industries, Inc.</u> 351 F.Supp. 1038 (E.D.Pa. 1972), <u>aff'd</u> , 480 F.2d 917 (3d Cir. 1973).....	9, 13, 14, 15, 17, 26, 28, 29
<u>In re Estate of Hinds</u> 10 Cal.App.3d 1021, 89 Cal.Rptr. 341 (Ct. of App. 1970).....	23
<u>In re Estate of Hoffman</u> 63 N.J. 69, 304 A.2d 721 (1973).....	26
<u>Hygrade Envelope Corp. v. Gibraltar Factors Corp.</u> 366 F.2d 584 (2d Cir. 1966).....	36, 37
<u>Joseph Kanner Hat Co., Inc. v. City Trust Co.</u> 482 F.2d 937 (2d Cir. 1973).....	37
<u>Porter v. Searles</u> 228 F.2d 748 (10th Cir. 1955).....	28, 29

<u>Statutes</u>	<u>Page</u>
Title 11 U.S.C. §1(19) (§1(19) of the Bankruptcy Act).....	34, 35
Title 11 U.S.C. §96(a)(b) (§60(a)(b) of the Bankruptcy Act).....	3, 11, 25, 27
Title 28 U.S.C. Federal Rules of Civil Procedure 6(a).....	24
12A N.J.S.A. §12A:1-102.....	18
12A N.J.S.A. §12A:9-202.....	12, 17
12A N.J.S.A. §12A:9-204.....	13
12A N.J.S.A. §12A:9-303.....	13
12A N.J.S.A. §12A:9-305.....	11, 12, 14, 17, 19, 22
12A N.J.S.A. §12A:9-306.....	24
5A Del.C. §1-102(1).....	18
5A Del.C. §1-102(2)(a) and (b).....	18
5A Del.C. §9-102.....	17

<u>Other Authorities</u>	
28 Am.Jur.2d 11, p. 18 (1966).....	23
3 Collier on Bankruptcy ¶60.32, p. 898 (1975).....	12
3 Collier on Bankruptcy ¶60.33, p. 900 (1975).....	25
3 Collier on Bankruptcy ¶60.39[2], p. 957 (1975).....	15
3 Collier on Bankruptcy ¶60.50, p. 1039 (1975).....	26
Restatement (Second) of Agency §14D (1958).....	22, 23
5 Rutgers-Camden L.J. 336 (1974).....	19, 28

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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S.E. STEIN, Trustee in Bankruptcy of
the Estate of Seaway Floor and Paving : APPELLANT'S BRIEF
Company, Inc., :
Plaintiff-Appellee, : Docket No.: 75-7291
-against- :
RAND CONSTRUCTION COMPANY, INC., :
Defendant-Appellant. :
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PRELIMINARY STATEMENT

In April, 1967 Rand Construction Company, Inc.
("Rand") and Seaway Floor and Paving Company, Inc. ("Seaway")
entered into a written agreement (Plt'f. Exh. 1 (17-20)*; here-
inafter "the Subcontract"). Under the Subcontract, Seaway was
to act as a subcontractor in connection with a construction pro-
ject undertaken by Rand as prime contractor for the State of New
Jersey at Skillman, New Jersey (the "Skillman Project").

In lieu of a performance and payment bond, written by
a surety company for the purpose of assuring Rand and the State
of New Jersey that Seaway's performance would be completed and
that Seaway's suppliers and materialmen would be paid, Seaway
entered into a contemporaneous agreement with Rand whereby the

* All references, unless otherwise indicated, are to pages in
the Appendix.

sum of \$25,000, evidenced by a Certificate of Deposit in Seaway's name, was eventually delivered as security. This agreement is set forth as Plt'f. Exh. 2 (21-23) and for ease of reference may be called the "Security Agreement". The Security Agreement stated at ¶2 (22), that such delivery was being made to Rand in escrow. In furtherance thereof, the Certificate of Deposit was, in fact, turned over to George Bohlinger, an attorney licensed to practice in the State of New Jersey (233-235).

In August, 1967 and thereafter, Rand had indications from various of Seaway's suppliers and union welfare funds on the Skillman Project that amounts owing by Seaway were overdue. Seaway explained this as resulting from a cash squeeze and stated to Rand that considerable sums were due it from other named parties arising out of other jobs (89-91). However, by October, 1967 Rand was concerned that those parties continue to work on the Skillman Project and Rand both guaranteed payment to certain of them and undertook to have Seaway pay these amounts.

Accordingly, at a meeting held October 26, 1967, representatives of Seaway and Rand agreed that the proceeds of the Certificate of Deposit held by Mr. Bohlinger be used to pay a portion of the monies due from the Skillman Project to Seaway's suppliers and union welfare funds. In furtherance of this understanding, on October 28, 1967 Seaway transmitted a letter of direction to the issuer of the Certificate of Deposit, Trenton

Trust Company, Plt'f. Exh. 14 (35) authorizing the proceeds to be made available to Rand to pay debts owed by Seaway to its suppliers and union welfare funds on this job.

This sequence of events is indicated in a letter dated October 26, 1967 from Mr. Bohlinger to Rand, which was presented in evidence as Plt'f. Exh. 16 (37). The \$25,000 became available for use by Rand on or after October 31, 1967, whereupon Rand commenced to issue checks in various sums made jointly payable to Seaway and certain of Seaway's suppliers and union welfare funds in payment of the indebtedness arising from the Skillman Project, Rand utilized the entire proceeds of the \$25,000 Certificate of Deposit in this manner.

Seaway filed a petition for Voluntary Bankruptcy in February 29, 1968. Plaintiff-appellee, as Trustee for the Estate of Seaway Floor and Paving, Inc. ("Seaway"), instituted this action in the United States District Court under Section 60 of the Bankruptcy Act, 11 U.S.C. §96, seeking the return of the \$25,000 in reference from Rand on the theory that it represented a voidable preference from Seaway.

The trial Court held that the transfer of the \$25,000 described above to Rand constituted a voidable preference to Rand. The Court based its decision on the grounds that the transfer of funds represented by the Certificate of Deposit was made by Seaway on or after October 31, 1967, placing the transfer

within the four-month statutory period immediately prior to the filing of Seaway's petition in Bankruptcy, and further held that Rand had reasonable cause to believe that Seaway was insolvent at the time of the transfer.

ISSUES PRESENTED FOR REVIEW

1. Did the Trial Court err in not finding that the transfer of Seaway's property took place either (a) when the Certificate of Deposit was delivered to Rand in April, 1967 or (b) when Seaway specifically agreed on October 26, 1967 to the release by the issuing bank of the funds evidenced thereby to Rand, both of which dates are without the four months statutory period?

2. Did the Trial Court err in finding that Rand received a voidable preference under §60 of the Bankruptcy Act, 11 U.S.C. §96 in that Rand was a forwarding agent for Seaway's creditors and received no payment of an antecedent debt within the meaning of that statute?

3. Did the Trial Court err in finding that Rand had reasonable grounds to believe that Seaway was insolvent at the time when the funds were transferred?

STATEMENT OF FACTS

On December 21, 1966, Rand was awarded a contract for

the erection of certain buildings and facilities for a training school for boys at Skillman, New Jersey (199-200). A subcontract for concrete work was awarded to Seaway prior to the signing of which certain discussions regarding the posting of a performance and payment bond took place (86, 87, 220, 221, 224-230). Seaway's officers stated that they were unable to obtain further bonding (225) but they would offer some kind of cash security in lieu of the bond. Rand found this arrangement acceptable and its general New York counsel, Mr. Ralph Heyman, prepared an agreement requiring the posting by Seaway of \$25,000 in cash to be placed in escrow. This arrangement was subsequently changed when Seaway's officers requested the substitution of an interest bearing Certificate of Deposit in the name of Seaway for such sum, the intent of this substitution being to allow Seaway to receive the interest which would accrue on this money. Rand's sometime New Jersey attorney, George Bohlinger was asked to aid in securing a Certificate of Deposit for Seaway, an Ohio firm, which presumably had few New Jersey contacts. A Certificate of Deposit was thereafter issued by Trenton Trust Company in the name of Seaway and was delivered to Mr. Bohlinger, pursuant to the Security Agreement.

On April 7, 1967, the Subcontract (17-20) and the Security Agreement (21-23) were signed and the Certificate of Deposit (24) was simultaneously or immediately thereafter

placed in escrow with Mr. Bohlinger. Testimony further indicates that, although Rand had not been represented by Mr. Bohlinger in the course of negotiating the agreements in reference, Mr.

Bohlinger was selected for reasons of convenience since he had previously represented Rand in New Jersey matters, and both the work to be performed was in that State and the Certificate of Deposit was issued by a New Jersey bank (231-234).

In July and August, 1967, Rand requested certain subcontractors' affidavits from Seaway (31, 32, 33). These affidavits were designed to assure Rand and the owner of the premises, the State of New Jersey, that employees and suppliers of Seaway were currently paid so that there was no danger of either a statutory lien being asserted by such persons or of their discontinuing the rendering of services or supplying of materials for the job. Testimony was introduced to the effect that such affidavits were common and standard operating procedure both for Rand and other contractors. However, Seaway declined to deliver such affidavits (95, 96). On August 31, 1967, Rand guaranteed Seaway's obligations to certain of its suppliers (26, 27, 28, 29). This action was taken to secure the continued rendering of services by these parties and to induce them to withhold the filing of statutory liens. During this time Seaway experienced cash flow problems (89, 90) wherein it had difficulty in meeting the current obligations it incurred on the Skillman

Project. The officers of Seaway testified that they were experiencing difficulty in obtaining payments from certain other jobs which, in turn, led to problems in meeting their other obligations (91).

On October 26, 1967, a meeting between the officers of Rand and Seaway took place in Rand's offices wherein Seaway acquiesced in the cashing in of the Certificate of Deposit for use of the proceeds to pay obligations to its suppliers and creditors on the Skillman Project (100-101, 157; Plt'f. Exh. 16, ¶1 (37)). Bohlinger was duly informed of the events and sent a letter (Plt'f. Exh. 13 (34)) dated October 26 to Rand stating that:

"Holding subject to your [Rand's] order, Certificate of Deposit of Trenton Trust Company, dated April 7, 1967, in the name of Seaway Floor and Paving Company, Inc. in the face amount of \$25,000." (emphasis added).

Bohlinger further stated that he would send the proceeds to Rand when he received from Seaway the necessary authorizations for the issuer. Seaway provided the authorization on October 28, 1967 (35) and Bohlinger received the proceeds on October 31, 1967 (38). From time to time thereafter, in reliance upon the fact that Seaway's materialmen and employees had been paid and were not asserting liens (which would have violated Article XXI of the subcontract (20)), Rand paid over substantial sums which it

owed to Seaway in respect of Seaway's performance of the subcontract (162). Seaway filed a Voluntary Petition in Bankruptcy on February 29, 1968.

Mr. Ralph Heyman, Rand's attorney, testified in an Examination Before Trial of Mr. Tanenbaum, that the intent of Rand and Seaway in establishing the Certificate of Deposit was to parallel the procedure of a performance and payment bond which Rand had required of subcontractors generally (226-228). This is confirmed by the testimony of plaintiff's witness, Mr. Ogletree (86-87). This is also indicated by the instrument itself which recites the waiver of the surety bond and duplicates the language of such a bond at paragraph 1:

"1. The Subcontractor acknowledges that it is held and firmly bound unto the Contractor in the sum of \$25,000.00 for payment of which well and truly to be made it hereby binds itself, its successors and assigns.

"The condition of the above obligation of this Paragraph 1 is such that if the Subcontractor shall well and faithfully perform all of the things required by it to be performed in accordance with the terms of the said Subcontract and in accordance with the plans and specifications therein referred to, and shall, in addition, pay all lawful claims of its Subcontractors, materialmen, laborers, persons, firms or corporations for labor performed or materials, provisions, provender or other supplies, teams, fuels, oils, implements or machinery used or consumed in, upon for or about the work and construction required by the Subcontract to be performed, then its obligation shall be void, otherwise, to remain in full force and effect."

The Security Agreement does not refer to Mr. Bohlinger or to any escrow agent but does recite that the Certificate of Deposit, specifically described by issuer and certificate number, has been delivered to the contractor (i.e., Rand) and contains a recitation that the contractor acknowledges receipt thereof (Plt'f. Exh. 2, p. 2, ¶2 (22)). There is a further reference in this agreement that such delivery of the Certificate of Deposit "is made in escrow" and that such Certificate of Deposit is to be returned to Seaway upon receipt of satisfactory evidence that claims by laborers, materialmen or suppliers on the job in reference have been paid or satisfied.

Mr. Tanenbaum further testified, in his deposition (245) and at the trial (178-180) that the Certificate of Deposit was being held by Mr. Bohlinger because Rand had confidence in Mr. Bohlinger to act on its behalf and had used Mr. Bohlinger for legal matters arising within the State of New Jersey on prior occasions (178, 231-232). There was also testimony by Mr. Tanenbaum in the EBT that Mr. Bohlinger had been retained by Seaway on subsequent occasions (232-233). The trial court, however, held that Mr. Bohlinger was an agent of neither party and inherently could not have been as a matter of law since he was an "escrow agent", basing such decision, in part, upon language contained in a Pennsylvania case affirmed without opinion by the Third Circuit: In re Dolly Madison Industries,

Inc., 351 F.Supp. 1038 (E.D.Pa. 1972), aff'd, 480 F.2d 917 (3d Cir. 1973).

The Court further held that the Certificate of Deposit was not delivered to Rand or its agent on April 7, 1967 when such Certificate of Deposit was delivered to Mr. Bohlinger, and accordingly, that Rand did not have a perfected security interest in the funds represented thereby until at least October 31, 1967 (when the cash represented by the Certificate of Deposit was released by the issuing bank), a date within four months (by two days) of the filing of the Petition of Bankruptcy by Seaway on February 29, 1968.

The Trial Court reached this decision despite uncontroverted evidence that on October 26, 1967, prior to the commencement of the four-month statutory period, Mr. Bohlinger had been notified and authorized by both Seaway and Rand to take the necessary steps to liquidate the Certificate of Deposit and place the funds subject to Rand's direction, for payment to Seaway's suppliers and union welfare benefits on the Skillman Project (37). There was further uncontroverted testimony and evidence that the entire \$25,000 represented by the Certificate of Delivery was paid over directly to such third parties and was not retained by Rand for its own use (Def't. Exh. F (71-76)).

POINT I

THE CERTIFICATE OF DEPOSIT WAS HELD BY THE ESCROW AGENT FOR RAND'S BENEFIT FROM ON OR ABOUT APRIL 7, 1967, THEREBY PERFECTING RAND'S INTEREST IN SUCH PROPERTY WELL IN ADVANCE OF THE FOUR MONTH PERIOD IMMEDIATELY PRECEDING THE FILING OF SEAWAY'S PETITION IN BANKRUPTCY.

Section 60(a)(1) of the Bankruptcy Act, 11 U.S.C.

§96(a) provides, in pertinent part, that:

"A preference is a transfer...of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or on behalf of him of the petition initiating a proceeding under this title...."

The testimony and evidence presented at trial indicates that, in accordance with the agreements of April 7, 1967 (17-20, 21-23), Seaway arranged for a Certificate of Deposit registered in its name to be contemporaneously issued in its name and delivered to George Bohlinger, Jr. as Escrow Agent. Under the Uniform Commercial Code, operative in the State of New Jersey, a Certificate of Deposit is regarded as a negotiable instrument, as recognized by the District Court. (Memorandum Decision (12). Perfection of a Security Interest in the Certificate of Deposit may only be effected by actual possession thereof. 12A N.J.S.A. 12A:9-305. If such security interest were to be perfected prior to the four-month period imposed by

Section 60(a) of the Federal Bankruptcy Act, 11 U.S.C. §96(a), then a later use or transfer of such funds by Rand within such four month period would not constitute a preference. 3 Collier on Bankruptcy ¶60.32, p. 898.

For purposes of perfecting such security interest, it is deemed irrelevant that the Certificate of Deposit was not endorsed for transfer by Seaway since title to the collateral is immaterial. 12A N.J.S.A. 12A:9-202. Accordingly, the fact that the interest accruing thereon was payable to Seaway rather than to any other party is also irrelevant.

The District Court clearly accepted the principle that possession of the Certificate of Deposit would be sufficient to perfect Rand's security interest therein (Memorandum, (13)). The Court, however, refused to accept the premise that Mr. Bohlinger was acting as an agent of Rand for purposes of receiving and holding such Certificate of Deposit.

If, Mr. Bohlinger were held to be acting as Rand's agent, it is clear that Rand would be deemed in possession of the Certificate of Deposit with a perfected interest therein. 12A N.J.S.A. 12A: 9-305 and Comment 2 specifies that a party may act through an agent under these circumstances. However, the District Court held that Mr. Bohlinger was an agent for neither party based upon the premises that (a) both Rand and Seaway had retained him on other matters (although there is testimony in

the EBT (231-233) to indicate that Seaway had retained Mr. Bohlinger at a subsequent date upon Rand's recommendation and not prior to the time of his designation as Escrow Agent) and (b) the very fact of an escrow under which the Certificate of Deposit was being held would negate the ability of either party, particularly Rand, to claim that it was in possession of such Certificate of Deposit.

For the latter thesis, the plaintiff and the Trial Court apparently relied heavily upon the decision in the Dolly Madison Industries case. The latter, decided under Pennsylvania law, related to a security agreement involving the purchase of the shares of capital stock of a privately held corporation.

The shares of stock were held under a security agreement which expressly stated that the seller's security interest in such shares would not attach until the default of the buyer. The Court held therein that, under Pennsylvania law, the nature of an escrow was inconsistent with the escrowee's acting as agent of either party. A further holding was that the intent of the parties, evidenced by the specific language of the escrow agreement, was such that the security interest in the shares was not intended to attach until after a default had occurred.

In the instant situation, the security interest in the Certificate of Deposit met the requirements of both attachment and perfection contained in N.J.S.A. 12A: 9-204, 9-303 and

9-305. These provide, in pertinent part, that a security interest will not attach unless and until the parties agree that it shall do so and value is given. In the Dolly Madison Industries situation, the security agreement specifically reflected the intention of the parties that the security interest not attach until after an uncured default by the purchaser. In the instant case, the terms of Plt'f. Exh. 2 (21-23) cited above, specifically provide that the delivery of the Certificate of Deposit is intended to be made to Rand contemporaneously with the signing of the Subcontract on April 7, 1967 to secure Seaway's obligations on the Skillman Project to its employees and suppliers.

There were unquestionably limitations upon Rand's ability to act unilaterally with respect to such collateral, but these were consistent with the arrangement agreed upon between the parties, whereby the Certificate was to represent a collateral under a bond. Accordingly, Rand was not to utilize the Certificate of Deposit for any other purpose than to secure payment to creditors of Seaway arising out of the Skillman Project, and to defray costs of completion. There is certainly a legitimate interest in protecting Seaway's interest by use of an attorney as escrow agent to assure Seaway that the Certificate of Deposit would not be dealt with dishonestly.

However, to apply the Dolly Madison decision arbitra-

rily to the instant situation would preclude businessmen from resorting to a legitimate, reasonable and sensible security device without any corresponding contradictory public policy. Since a security interest in negotiable instruments of this sort is perfected only by possession, and the Certificate of Deposit was not in the hands of Seaway during the relevant periods of time, no creditors of Seaway could have been misled or relied upon Seaway's purported unrestricted ownership thereof - and no parties other than Rand and the Seaway creditors on the Skillman Project who were paid with its proceeds actually did rely upon the Certificate of Deposit!

Whether or not Dolly Madison Industries can be totally distinguished from the facts of our case may not be altogether relevant since it is also appellant's position that the holding in that case is not binding on the Court in the instant matter. The perfection of the security interest in the instant case is a matter governed by the laws of the State of New Jersey. 3 Collier on Bankruptcy ¶60.39[2] p. 957.

The holding by the District Court in the instant case that Mr. Bohlinger could not, as a matter of law, be an agent for Rand for purposes of holding the Certificate of Deposit because the existence of a pledge and escrow agreement in simultaneous form is impossible, should not be allowed to stand. The agreements between Rand and Seaway providing for

this security arrangement are contracts operative between the parties which express their intent and should be given legal and binding recognition and force by the courts. Nothing was alleged to be done by such parties which is illegal or contrary to public policy. In clear form, the parties agreed and contracted to deliver to Rand the Certificate of Deposit to be held to insure Seaway's payment of certain indebtedness then or thereafter arising to third parties. As an attorney entrusted with a fiduciary obligation to act in accordance with the specific instructions from the parties to the escrow agreement, Mr. Bohlinger was not precluded from acting as agent for either party for the purpose of carrying out a specific function. In this case, Mr. Bohlinger was directed by the parties to act on Rand's behalf to hold the Certificate of Deposit which the Security Agreement provided was being delivered to Rand. Presumably, the reason for the designation of Mr. Bohlinger to hold the Certificate of Deposit instead of an employee of Rand was both for convenience of the parties (since Mr. Bohlinger's office was in the State of New Jersey whereas Rand was located in New York) and perhaps more importantly, to insure that the Certificate of Deposit not be used for any unauthorized purpose by Rand. As an attorney, Mr. Bohlinger was regarded by the parties as being more trustworthy and more subject to penalty for dereliction

of his duty in a matter of this nature.

A recent decision, Barney v. Rigby Loan & Investment Co., 344 F.Supp. 694 (D. Idaho, 1972), expressly held that under the laws of that state, an attorney could act as agent for several parties with differing interests and "was bound in good faith to carry out the terms and conditions of the trust." The fact that "[he] was also the attorney for the Bankrupt does not legally preclude the parties from the right to select him as trustee-bailee or as a pledge holder." 344 F.Supp. 694 at 697. That case concerned a trustee who had possession of checks which were not endorsed. The Court there held that the possession of such negotiable instruments was sufficient to satisfy the provision respecting perfection of a security interest in Idaho analagous to NJSA 12A:9-305 and further held that legal title in the bailee was not required under the Uniform Commercial Code in order to perfect a security interest in negotiable instruments. 344 F.Supp. 694 at 696. New Jersey law is clearly in accord on this point since Section 12A:9-202 expressly provides that title to the collateral is immaterial.

Another recent case which distinguished the Dolly Madison Industries decision is In re Copeland, 391 F.Supp. 134 (D.Delaware 1975). The District Court refused to apply the technical, literal reading of the Delaware provision of U.C.C. §9-305. The Court (at 391 F.Supp. 150) cited §9-102 and the

comments thereunder as stating the purpose and policy of Article 9 of the Code. These statements equally apply under the New Jersey version of the Uniform Commercial Code. The Copeland court reiterated the purposes of requiring possession of the collateral. The Court stated:

"Where, as here, physical possession of the stock certificate was voluntarily given up by Copeland [debtor] and placed with W.T.C. [escrow agent] with the agreement and the acquiescence of Pension Benefit [creditor], the effective notice to other potential creditors was precisely the same as if Pension Benefit had taken possession of the Christiana stock certificates, i.e., Copeland was without the certificates." (391 F.Supp. at 151.)

The Court went on to recognize that unless possession by an escrow agent was recognized, the purposes of the code as expressed in §1-102(1) would be frustrated. The Court stated:

"A result which would require importation of common law niceties into the Code provides a trap for the unwary and would be a corruption of the Code's controlling rule of construction that it 'shall be liberally construed and applied to promote its underlying purposes and policies.' 5A Del.C. §1-102(1).

Among these underlying purposes are:

- '(a) to simplify, clarify and modernize the law governing commercial transactions;
- '(b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties.' 5A Del.C. §1-102(2).

"Thus, for this Court 'to hold that an escrow arrangement can never protect [a] creditor from [third party lienholders or the powers of a bankruptcy trustee or debtor-in-possession]' would be to elevate 'technicality over substance and [negate] the reasonableness the Code hoped to impart to commercial practices.'" [5 Rutgers-Camden L.J. 336, 344 (1974)] 391 F.Supp. 134 at 151. (emphasis added)

The New Jersey provisions of the Code are precisely the same, (see 12A N.J.S.A. 12A:1-102).

The facts of the case at bar clearly indicate the intention of the parties to create a security interest in Rand in the Certificate of Deposit. Similarly, it is clear that this security agreement took the form of a pledge. The effective date of this transaction was on April 7, 1967 when the parties signed the agreement designated as Plt'f. Exh. 2 (21-23), and Seaway purchased the Certificate of Deposit and gave Rand possession of that Certificate of Deposit and Rand placed it in escrow. As of April 7, 1967 Rand effectively removed the Certificate of Deposit from Seaway's possession and put it into the actual possession of Bohlinger as escrow agent. For purposes of notification to other creditors who might be misled by Seaway, the object of §9-305 was effectively satisfied.

Accordingly, Rand's security interest in the Certificate of Deposit should be held to have attached on and as of April 7, 1967 when the same was issued and delivered to Rand

and Mr. Bohlinger and no preference should be deemed to have occurred by virtue of Rand's actions thereafter.

POINT II

IF THE TRANSFER OF OR PERFECTION OF RAND'S INTEREST IN THE CERTIFICATE OF DEPOSIT IN REFERENCE IS NOT DEEMED TO HAVE OCCURRED ON APRIL 7, 1967, THEN IT SHOULD BE HELD TO HAVE OCCURRED ON OCTOBER 26, 1967, SEVERAL DAYS PRIOR TO THE FOUR MONTH STATUTORY PERIOD.

Mr. Bohlinger, as agent holding the Certificate of Deposit, confirmed the parties in writing that, based on their instructions of the past Thursday (i.e., October 26, 1967), he was taking the necessary steps to liquidate the Certificate of Deposit in reference and place the funds at the disposal of Rand for payment of Seaway's creditors upon the Skillman Project (see letter of October 31, 1967 (37)). There was also testimony in the record by Messrs. Tanenbaum and (157) Ogeltree (102) to the effect that a meeting was held between the parties on October 26, 1967 at which time Rand insisted upon, and Seaway acquiesced in, the release and payment of the funds represented by such Certificate of Deposit.

Accordingly, even if the Court were to hold that the Security Agreement contained a condition of default or acquiescence by Seaway prior to Rand's being entitled to possession of the Certificate of Deposit and prior to the escrow agent's being entitled to act solely as Rand's agent for such purpose, then such conditions must be found to have been met no later than October 26, 1967, a date at least three days

prior to the commencement of the four-month period during which a preference would be measured.

The foregoing is bolstered by the specific language of NJSA 12A:9-305 of the Uniform Commercial Code, as adopted by the State of New Jersey, and Comment 2 thereof, which focus upon the time ~~that~~ the bailee (i.e., Bohlinger) receives notification of the secured party's interest in the collateral:

"A security interest in letters of credit ...goods, instruments, money, negotiable documents or chattel paper may be perfected by the secured party's taking possession of the collateral. If such collateral...is held by a bailee, the secured party is deemed to have possession from the time the bailee receives notification of the secured party's interest...." (emphasis added).

Official Comment 2 provides:

"Where the collateral...is held by a bailee, the time of perfection of the security interest, under the second sentence of the section, is when the bailee receives notification of the secured party's interest: This rule rejects the common law doctrine that it is necessary for the bailee to attorn to the secured party or acknowledge that he now holds on his behalf." (emphasis added).

The District Court recognized the requirements of 12A:9-305 but failed to find that Bohlinger was the agent of Rand for purposes of accepting possession of the Certificate of Deposit even on October 26, 1967. Memorandum Decision, (13).

In furtherance thereof, the Restatement, Agency 2d §14D, provides:

"An escrow agent is not as such agent of either party to the transaction until the event occurs which terminates the escrow relation."

Comment b:

"When the escrow succeeds or fails...If the event happens which is to complete the transaction, the escrow holder becomes the agent in possession of the property or the holder of the title for the new owner." (emphasis added).

See also 391 F.Supp. 134 at 148, citing the above.

28 Am.Jur.2d §11, p. 18 explains as follows:

"It has also been said that the depository is the agent or trustee for both parties until performance of the condition, but thereafter the dual agency changes to an agency not for both, but for each of the parties to the transaction in respect to those things placed in escrow to which each has become completely entitled." (emphasis added).

In, In re Estate of Hinds, 10 Cal.App.3d 1021, 1024 Cal. Reprtr. 341, 343 (1970), the California Court of Appeals interpreting §9-305 stated in dictum that notification to the escrow holder [of secured parties interest] would have been sufficient to gain possession.

It is clear from certain documents and evidence that were contemporaneous with the discussion that took place in October of 1967 (Plt'f. Exh. Nos. 13 (34) and 16 (37)), that the parties agreed on or before October 26, 1967, and that the escrow agent Bohlinger was made aware of this fact,

that Seaway had failed in its obligations to pay its creditors under the April 7th Security Agreement and that Rand should promptly utilize the funds evidenced by the Certificate of Deposit to pay the various materialmen, laborers and employees of Seaway on the Skillman Project. Plt'f. Exh. No. 13 (34), a letter dated October 26, 1967, from Mr. Bohlinger to Rand stated:

"Please be advised that I am holding subject to your order, Certificate of Deposit of Trenton Trust Company, dated April 7, 1967, No. CD7937 in the name of Seaway Floor and Paving Co., Inc. in the face amount of \$25,000.00." (emphasis added).

The letter goes on to recite the procedures that will be taken by Bohlinger to obtain the proceeds of the Certificate of Deposit for the benefit of Rand. The Trial Court, at page 6 of the Memorandum Decision (11), stresses the importance of the receipt by Rand of the proceeds of the Certificate of Deposit at a later date, perhaps November 2nd or 3rd. This appears to confuse N.J.S.A. §12A:9-306 with the requirements of possession of the collateral. The Code explicitly differentiates between the proceeds of the security interest and the security interest in collateral itself, and the Court apparently failed to recognize this distinction.

In Plt'f. Exh. No. 16 (37), a letter by Bohlinger to Rand Construction Company dated October 31, 1967 Bohlinger was transmitting the proceeds of the Certificate of Deposit to Rand

based on the "understanding which was had with Mr. Ogletree [Vice President of Seaway] at the time of our arrangement last Thursday [October 26, 1967] was that the entire proceeds of the Certificate of Deposit were to be paid to Rand."

The District Court below found that the bankruptcy was filed on February 29, 1969. Section 60(a) provides that, in order for a transfer to constitute a preference, the transfer must have occurred "within four months before the filing by or against him of the petition initiating a proceeding under this Act."

"In computing the time, Rule 906(a), which provides for the application of the Federal Rule of Civil Procedure 6(a), governs, so that the first day is excluded, the last day included. Accordingly, the date the alleged transfer is effected will not be counted, but the day of the filing of the petition will be counted." 3 Collier on Bankruptcy ¶60.33 at p. 900.

Utilizing the above test, it is clear that the last date on which a transfer would be voidable was October 29, 1967. Thus, a finding that perfection was achieved on October 26, 1967 would lay outside the four month statutory period by three days. Similarly, the formal authorization by Seaway to Trenton Trust (unnecessary because it related to title; see discussion, supra, p. 12) executed on October 28, 1967 would also lay outside the four month period.

POINT III

EVEN IF RAND SHOULD BE FOUND NOT TO HAVE PERFECTED ITS SECURITY INTEREST IN THE CERTIFICATE OF DEPOSIT ON APRIL 7, 1967 OR OCTOBER 26, 1967, RAND WAS ENTITLED TO AN EQUITABLE LIEN THEREIN AT THAT TIME WHICH SHOULD BE GIVEN EFFECT.

The applicability of the doctrine of equitable liens is initially a matter of state law, subject to the limitation imposed by the Federal Bankruptcy Act. 3 Collier on Bankruptcy, ¶60.50 at p. 1039. The requirements of equitable liens were stated with specificity by the New Jersey Supreme Court in a recent decision. In re Estate of Hoffman, 63 N.J. 69, 304 A.2d 721 (1973). The Court at 63 N.J. 77, 304 A.2d 725, quoting from an earlier Chancery decision, stated:

"The whole doctrine of equitable liens or mortgages is founded upon that cardinal maxim of equity which regards as done that which has agreed to be, and ought to have been, done. To dedicate property, or to agree to do so, to a particular purpose or debt is regarded in equity as creating an equitable lien thereon in favor of him for whom such dedication is made. This wholesome equitable principal is one of wide, if not universal, recognition and application. [citations omitted]

"The form which an agreement shall take in order to create an equitable lien or mortgage is quite immaterial for equity looks at the final intent and purpose rather than at the form. If an intent to give, charge, or pledge property, real or personal, as security for an obligation, appears, and

the property or thing intended to be given, charged, or pledged is sufficiently described or identified, then the equitable lien or mortgage will follow as of course [citations omitted]." [emphasis added]

The above language makes clear that, as far as New Jersey law is concerned, the intent of the parties is paramount. The Security Agreement (Plt'f. Exh. 2 (21-23)) clearly expresses the intention to create a fund consisting of \$25,000 to secure Seaway's obligations in favor of Rand and Seaway's employees and suppliers on the Skillman Project. Equally clear is the intent to deposit as security for the above-mentioned obligation the Certificate of Deposit that was obtained by Seaway and delivered to Mr. Bohlinger "in escrow". Accordingly, it is clear that the requirements of an equitable lien under the law of New Jersey have been satisfied. The record contains additional evidence of the expressed intention of the parties. See Appendix (86, 87, 224-230).

The implications of the Federal Bankruptcy Act on this issue are that it is stated to be contrary to the policy thereof to recognize equitable liens "where available means of perfecting liens have not been employed...." Section 60(a)(6) Federal Bankruptcy Act, 11 U.S.C.A. §96(a)(6). Should this Court agree with the District Court and hold that Rand did not receive possession of the Certificate of Deposit on April 7, 1967 and thereby not perfect its interest therein because Mr.

Bohlinger, as escrow agent cannot act as agent for either party in such circumstances, as implied by the Dolly Madison Industries decision, then it is appellant's contention that the Court should recognize that Rand had an equitable lien in the Certificate of Deposit at that time. Based upon the interpretation of Dolly Madison Industries that the District Court reached, a recent New Jersey commentary stated "when the Certificate of Deposit is in the hands of an escrow agent who acts for neither party until the conditions of the escrow agreement arise, no overt action could possibly perfect a security interest in [a Certificate of Deposit] under the code as interpreted by the Dolly Madison court." 5 Rutgers-Camden Law Journal 336 at p. 346 (1974). Accordingly, it would follow that if the legal means of perfecting an equitable lien under the instant facts (i.e., having the collateral held by an attorney in trust cannot be employed), then an equitable lien would thus be established under New Jersey law and permissible under relevant provisions of the Bankruptcy Act.

Porter v. Searle, 228 F.2d 748 (10th Cir. 1955) a landmark case which interpreted this section of the Bankruptcy Act, concerned a sequence of events similar to those at bar. The Court discussed the transactions as follows:

"Here, the equitable lien of the Searles came into being immediately when Greenband refused to give the chattel mortgage. Delivery of the stock of merchandise to Greenband constituted a present consideration for the balance of the purchase price and the equitable lien which came into being to secure the same. There was nothing further that the Searles needed to do under Utah law to perfect their equitable lien. There was no means available to the Searles by which they could have converted it into a legal lien.

"The stock of merchandise was not surrendered to the Searles by Greenband to perfect their lien, but to satisfy the debt secured by the lien and to discharge the lien. It was an enforcement device and not a perfecting device that the Searles employed." at 228 F.2d 755.

For Rand the equitable lien came into being immediately upon the signing of the April 7, 1967 agreement. The physical delivery of the Certificate of Deposit to Rand constituted a security for the obligation mentioned in the agreement. There was no means available to Rand by which they could have converted it to a legal lien. The receipt of funds evidenced by the Certificate of Deposit between October 28 and October 31, 1967, was a means of discharging the lien. It was an enforcement device and not a perfecting device that Rand employed.

It is submitted that if this Court upholds the reasoning of the District Court in applying the rule of Dolly Madison Industries, then the equitable lien which arose on April 7, 1967 would have to be sustained in that no legal means of perfection would then be possible where an attorney is

acting as an escrow agent.

POINT IV

RAND RECEIVED NO FUNDS FROM THE
DEBTOR'S PROPERTY AND ACCORDINGLY
SHOULD NOT BE DEEMED TO HAVE RE-
CEIVED A PREFERENCE.

The Security Agreement (21-23) clearly states that the Certificate of Deposit was being held to secure obligations of Seaway to materialmen and suppliers arising out of the Skillman Project; such sums were not owing. The Subcontract and the Security Agreement both obligated Seaway to pay Seaway's creditors on a current basis. This was so that there would be no liens asserted and so that Rand, as general contractor, could be assured that the job would not be interrupted by refusal of such persons to continue to furnish services to Seaway on this project.

There was no direct monetary obligation owing by Seaway to Rand at any point in time. On the contrary, as the testimony clearly shows (157-159), Rand owed Seaway substantial sums of money. These amounts accrued from Seaway's performance on the Skillman Project by ^{way} ~~was~~ of a retainage from progress payments in accordance with the Subcontract. Such sums were ultimately paid over to Seaway subsequent to October 31, 1967 (162). Accordingly, in no sense can it be argued that Seaway was indebted to Rand for any sums of money.

The evidence is also clear both at testimony in the trial (162) and by the checks drawn by Rand jointly to Seaway and

Seaway's creditors (Def't. Exh. F (71-76)) that the moneys received in liquidation of the Certificate of Deposit were utilized specifically and directly for the payment of Seaway's creditors arising out of the Skillman Project. If a voidable preference is to be asserted by the trustee in bankruptcy of Seaway, it should be asserted against the parties actually receiving these amounts rather than against Rand. It is admitted by appellant that Rand did, in fact, benefit from the payment of Seaway's creditors because, among other things, as noted above, Rand had guaranteed payment of sums to certain of these creditors in order to induce them to continue their performance on the Skillman Project. However, for purposes of retrieving a voidable preference under the Federal Bankruptcy Laws, a general benefit of this nature should not be deemed the receipt of funds in respect of "an antecedent debt".

Brinig v. American Credit Bureau, Inc., 439 F.2d 43, (9th Cir. 1971) dealt with a situation whereby a collection agency was the assignee of accounts of furniture manufacturers and suppliers. In the course of its activities, the collection agency received moneys from a corporation within four months of a filing of a bankruptcy petition by that debtor. The collection agency, retaining its 20 per cent fee, forwarded the remainder of the moneys collected to the various assignors of the accounts. The trustee in bankruptcy of the debtor brought

an action under the Bankruptcy Act to require the collection agency to remit all the sums collected from the debtor within the four month period prior to filing of the petition on the grounds that the collection agency had received a voidable preference. The Court held against the trustee on the grounds that the defendant was no more than a mere conduit or agent for the creditors for purposes of collection. Accordingly, the credit bureau was solely an intermediary and was not the beneficial owner of those funds, (439 F.2d 43 at 47). This even precluded the defendant therein from being forced to remit the fee that it had received for its activities.

The "benefit" accruing to this defendant was no more tangible a benefit than that received by Rand in the instant situation. An intermediary rarely acts in a purely gratuitous status in such a matter. Accord, Carson v. Federal Reserve Bank, (1930) 254 N.Y. 218, 172 N.E. 475.

POINT V

RAND DID NOT HAVE REASONABLE CAUSE
TO BELIEVE THAT SEAWAY WAS INSOL-
VENT AT THE TIME OF THE TRANSFER
OF THE DEBTOR'S PROPERTY.

As noted by the Trial Court, even if appellant were deemed to have received a preference, it is not liable to the trustee unless, at the time of receipt thereof, "it had reasonable grounds to believe that the debtor was insolvent". The Trial Court found, as a matter of fact and law, that Rand had reasonable cause to believe that Seaway was insolvent at the time the transfer was made because of Seaway's (a) non-payment of bills, (b) requests for advances on moneys due to meet its payroll, (c) refusal to supply the subcontractor's affidavits, and (d) demand from certain suppliers of Seaway for a guarantee from Rand. The Court reached this conclusion despite both the Court's own awareness of the problems in the industry (174), and testimony that cash flow problems of the type experienced by Seaway were commonplace in the industry (169-170), indeed almost the rule rather than the exception. Furthermore, it is clear that the test of insolvency required by the statute is not the inability to pay one's debts when they become due (the equitable test) but is rather the balance sheet or bankruptcy test provided in Section 1(19) of the Bankruptcy Act:

"A person shall be deemed insolvent within the provisions of this Act whenever the aggregate of his property,...shall not at fair valuation be sufficient in amount to pay his debts."

Accordingly, although Rand may have been aware of Seaway's cash inability to meet its current obligations, that is not indicative that Rand was aware or should have been aware of Seaway's insolvency. In fact, the testimony at the trial by Mr. Ogletree, Vice President of Seaway, was to the effect that he had informed Rand that Seaway was owed approximately \$90,000 from certain other specified parties and that, based upon these representations, Rand had been requested to advance sums to Seaway.

While the Court's decision recites the facts that Seaway had advised Rand of "cash flow" problems and that a request by materialmen for guarantees of payment from the prime contractor was "not uncommon to the construction industry" (Memorandum, (9)) the Court also enunciates, as two of the reasons for its finding that Rand should have known Seaway was insolvent, the facts that there were demands for guarantees and that Seaway had requested advances to help meet its payroll (Memorandum, (14)). These findings of fact are both inconsistent and inappropriate for a holding that Rand had reason to believe Seaway was insolvent.

Plaintiff-appellee relied heavily on the case of

Hygrade Envelope Corp. v. Gibraltar Factors Corp., 366 F.2d 584 (2nd Cir. 1966). In that proceeding, the creditor had knowledge at the time of a transfer by the debtor, that the ^{debtor} creditor had deliberately written up one of its largest accounts to include goods which the customer had not ordered. Accordingly, the circumstances involving a fictitious or partially fictitious account assigned to a creditor who was a commercial factor, and who accordingly placed great credence upon the validity of the accounts assigned to it, were deemed to constitute sufficient notice to alert an ordinarily prudent businessman that the financial affairs and condition of the debtor were totally suspect. In fact, the Court there held that:

"There could scarcely be a clearer case for considering inquiry of the debtor to be insufficient and where it acknowledged the falsification discovered by the creditor was not the only instance and where this was found in many of the largest accounts." 366 F.2d at 587.

In contrast to that situation, the case at bar presented a one-time transaction between Rand and an out-of-state corporation with which Rand had no previous experience.

It is submitted that the vastly different factual situation between Hygrade Envelope and the case at bar necessarily require that this Court distinguish those conditions which would give a creditor cause to question the solvency

of the debtor.

In reversing the Trial Court on this point, this Court is not limited to a "clearly erroneous" finding. As this Court stated the well settled rule in Hygrade:

"...When the issue is his application of a legal standard to facts undisputed or reasonably found, reversal is not limited to results that are 'clearly erroneous'; it is enough that the Appellate Court should be convinced, as we are here, that the result does not jog with the applicable rule of law." 366 F.2d at 588.

In accord, Joseph Kanner Hat Co., Inc. v. City Trust Co., 482 F.2d 937, at 939 (2nd Cir. 1973); Danielson v. Joint Board of Coat, Suit and Allied Garment Workers Union, 494 F.2d 1230, at 1244 (2nd Cir. 1974).

Unlike the facts in Hygrade Envelope Corp., supra, Rand had no knowledge of any falsification of books or records nor did Rand have any knowledge of any kind that would require it to make further investigations of the bankrupt. It is the absence of such conditions that persuaded Rand to continue making payments to both materialmen and suppliers and the bankrupt itself from November 3, 1967 through January 3, 1968. See Def't. Exh. F (71-76).

Sections 60(a) and (b) of the Bankruptcy Act require that a determination of insolvency be made at the time of the alleged transfer. If the transfer is deemed to have been made

on April 7, 1967, there is no evidence in the record to sustain a finding that Rand had reasonable cause to believe Seaway insolvent, and, in any event, this would occur well in advance of the four month period measuring a preference. If the transfer is deemed to have been made on October 26, 1967 or October 28, 1967, the finding of the District Court below again comes into play, and it is respectfully submitted the District Court erred in its application of the Bankruptcy Rule of insolvency to the facts in the record.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the District Court erred in its findings that Rand received a voidable preference under Sections 60(a) and (b) of the Bankruptcy Act, 11 U.S.C.A. Sections 96(a) and (b) and that this Court reverse said decision.

Respectfully submitted,

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ADDENDUM

INDEX
TO
ADDENDUM

<u>STATUTES</u>	<u>PAGE</u>
Title 11 U.S.C. § 1(19)	i
Title 11 U.S.C. § 96 (a) and (b)	i
12A N.J.S.A. 12A: 9-202	v
12A N.J.S.A. 12A: 9-204	viii
12A N.J.S.A. 12A: 9-303	xv
12A N.J.S.A. 12A: 9-305	xviii
12A N.J.S.A. 12A: 9-306	xx

TITLE 11 U.S.C. § 1 (19)

A person shall be deemed insolvent within the provisions of this Act whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts;

TITLE 11 U.S.C. § 96
(BANKRUPTCY ACT § 60)

§ 60. Preferred Creditors. a. (1) A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

(2) For the purposes of subdivisions a and b of this section, a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee. A transfer of real property shall be deemed to have been made or suffered when it became so far perfected that no subsequent bona fide purchase from the debtor could create rights in such property superior to the rights of the

transferee. If any transfer of real property is not so perfected against a bona fide purchase, or if any transfer of other property is not so perfected against such liens by legal or equitable proceedings prior to the filing of a petition initiating a proceeding under this Act, it shall be deemed to have been made immediately before the filing of the petition.

(3) The provisions of paragraph (2) shall apply whether or not there are or were creditors who might have obtained such liens upon the property other than real property transferred and whether or not there are or were persons who might have become bona fide purchasers of such real property.

(4) A lien obtainable by legal or equitable proceedings upon a simple contract within the meaning of paragraph (2) is a lien arising in ordinary course of such proceedings upon the entry or docketing of a judgment or decree, or upon attachment, garnishment, execution, or like process, whether before, upon, or after judgment or decree and whether before or upon levy. It does not include liens which under applicable law are given a special priority over other liens which are prior in time.

(5) A lien obtainable by legal or equitable proceedings could become superior to the rights of a transferee or a purchase could create rights superior to the rights of a transferee within the meaning of paragraph (2), if such consequences would follow only from the lien or purchase itself, or from such lien or purchase followed by any step wholly within the control of the respective lien holder or purchaser, with or without the aid of ministerial action by public officials. Such a lien could not, however, become so superior and such a purchase could not create such superior rights for the purposes of paragraph (2) through any acts subsequent to the obtaining of such a lien or subsequent to such a purchase which require the agreement or concurrence of any third party or which require any further judicial action, or ruling.

(6) The recognition of equitable liens where available means of perfecting legal liens have not been employed is hereby declared to be contrary to the policy of this section. If a transfer is for security if (A) applicable law requires a signed and delivered writing, or a delivery of possession, or a filing or recording, or other like overt action as a condition to its full

validity against third persons other than a buyer in the ordinary course of trade claiming through or under the transferor and (B) such overt action has not been taken, and (C) such transfer results in the acquisition of only an equitable lien, then such transfer is not perfected within the meaning of paragraph (2). Notwithstanding the first sentence of paragraph (2), it shall not suffice to perfect a transfer which creates an equitable lien such as is described in the first sentence of paragraph (6), that it is made for a valuable consideration and that both parties intend to perfect it and that they take action sufficient to effect a transfer as against liens by legal or equitable proceedings on a simple contract: *Provided, however,* That where the debtor's own interest is only equitable, he can perfect a transfer thereof by any means appropriate fully to transfer an interest of that character: *And provided further,* That nothing in paragraph (6) shall be construed to be contrary to the provisions of paragraph (7).

(7) Any provision in this subdivision a to the contrary notwithstanding if the applicable law requires a transfer of property other than real property for or on account of a new and contemporaneous consideration to be perfected by recording, delivery, or otherwise, in order that no lien described in paragraph (2) could become superior to the rights of the transferee therein, or if the applicable law requires a transfer of real property for such a consideration to be so perfected in order that no bona fide purchase from the debtor could create rights in such property superior to the rights of the transferee, the time of transfer shall be determined by the following rules:

I. Where (A) the applicable law specifies a stated period of time of not more than twenty-one days after the transfer within which recording, delivery, or some other act is required, and compliance therewith is had within such stated period of time; or where (B) the applicable law specifies no such stated period of time or where such stated period of time is more than twenty-one days, and compliance therewith is had within twenty-one days after the transfer, the transfer shall be deemed to be made or suffered at the time of the transfer.

II. Where compliance with the law applicable to the transfer is not had in accordance with the provisions of subparagraph I, the transfer shall be deemed to be made or suffered at the

time of compliance therewith, and if such compliance is not had prior to the filing of the petition initiating a proceeding under this Act, such transfer shall be deemed to have been made or suffered immediately before the filing of such petition.

(8) If no such requirement of applicable law specified in paragraph (7) exists, a transfer wholly or in part, for or on account of a new and contemporaneous consideration shall, to the extent of such consideration and interest thereon and the other obligations of the transferor connected therewith, be deemed to be made or suffered at the time of the transfer. A transfer to secure a future loan, if such a loan is actually made, or a transfer which becomes security for a future loan, shall have the same effect as a transfer for or on account of a new and contemporaneous consideration.

b. Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: *Provided, however,* That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.

12A:9-202. Title to Collateral Immaterial.

Each provision of this Chapter with regard to rights, obligations and remedies applies whether title to collateral is in the secured party or in the debtor. L.1961, c. 120, § 9-202.

New Jersey Study Comment

1. The purpose of § 9-202 is to render immaterial the question of whether title to collateral is in the debtor or secured party when adjudging the rights, obligations and remedies provided for in Article 9. This section is designed to abolish classifications among security devices dependent upon conceptual analysis of "title" to the collateral. Consequently, the rights, obligations and remedies provided for in Article 9 are not affected by the classification a particular security device would have under present New Jersey law, such as chattel mortgages, conditional sales, bailments, or the like.

2. This section changes a considerable body of New Jersey law wherein the title concept is the prime factor in distinguishing between various types of personal property security devices. Since under present New Jersey law, the rights, obligations and remedies of the parties are initially determined by form of the security device, it follows that the location of "title" to the collateral is of critical import. Under present law location of title is the determinative factor in the following situations:

A. Sale or Conditional Sale: In *Lott v. Delmar*, 2 N.J. 229 (1949) the Supreme Court ruled that in a conditional sale "title would of necessity remain in

the vendor, for a 'conditional sale' is a contractual device by which property in the goods is not transferred until payment of part or all of the price or compensation, or upon the performance of the condition or the happening of the contingency stipulated." *Id.* at p. 234. [See also, *In re Lindsey*, 131 F.Supp. 11 (N.J.1955) as to effect against a trustee in bankruptcy of a reserved title in unrecorded bill of sale.] *In re Press Printers & Publishers* 12 F.2d 660 (3d Cir.1926).

B. Sale or Mortgage: Where title is transferred to the borrower by a lender and/or seller the transaction cannot be a conditional sale, but is a chattel mortgage. See, *Security National Bank of Trenton v. Bell*, 125 N.J.L. 640, 17 A.2d 552 (E. & A.1941); *Hastings v. Fithian*, 71 N.J.L. 311, 60 Atl. 350 (E. & A.1905); and *Harding v. First-Mechanics National Bank*, 113 N.J.Eq. 129, 166 Atl. 142 (E. & A.1933). Thus, the form which a security transaction can take is governed in the first instance by a determination of who has title as between the secured party and the debtor.

C. Sales and Bailments: The law of New Jersey is somewhat unclear as to whether a sale and bailment is in essence a conditional sale or a *sui generis* security device. In *Commercial Credit Corporation v. Satterthwaite*, 107

N.J.L. 17, 150 Atl. 235, *aff'd*, 108 N.J.L. 188, 154 Atl. 769 (E. & A. 1931), the Supreme Court relying on R.S. 46:32-2(2) declared:

There seems to be some doubt in many of the cases as to whether a conditional sale is to be classed as a bailment. Under subdivision 2 of section 1, [46:32-2(2)] . . . the statute expressly defines it as a bailment; and we see no reason why it should be a bailment in one portion of that section and not subject to the same rules and classification in the other portion. In both subdivisions the general property remains in the seller, and only a special property passes to the buyer until the chattel has been paid for. This is one of the fundamental ideas of the law of bailment, . . . Id. 150 Atl. p. 236.

While the County Circuit Court of Bergen County held in *Kelly v.*

Tierney, 40 N.J.L.J. 72 (1917) that a questioned security transaction amounted to a conditional sale, the form of the opinion implied that the transaction might amount also to an unregulated sale and bailment, an implication inconsistent with the construction of the Conditional Sales Act set forth in *Commercial Credit Corporation v. Satterthwaite*, *supra*. The enactment of § 9-202 would render a resolution of this particular issue immaterial.

D. *Bankruptcy*: Grants or denials of petitions for reclamation in bankruptcy often turned upon an analysis of the location of title as between the putative secured party and the debtor. *Cf.* In re *Lindsey*, 131 F.Supp. 11 (N.J. 1955). To the extent that state law controls in such reclamation proceedings or in summary turnover proceedings, § 9-202 renders title location irrelevant. See, § 9-507 *infra*.

Uniform Commercial Code Comment

Prior Uniform Statutory Provision: None.

Purposes:

The rights and duties of the parties to a security transaction and of third parties are stated in this Article without reference to the location of "title" to the collateral. Thus the incidents of a security interest which secures the purchase price of goods are the same under this Article whether the secured party appears to have retained title or the debtor appears to have obtained title and then conveyed it

or a lien to the secured party. This Article in no way determines which line of interpretation (title theory v. lien theory or retained title v. conveyed title) should be followed in cases where the applicability of some other rule of law depends upon who has title. Thus if a revenue law imposes a tax on the "legal" owner of goods or if a corporation law makes a vote of the stockholders prerequisite to a corporation "giving" a security interest but not if it acquires property "subject" to a security interest, this Article does not attempt to define

whether the secured party is a "legal" owner or whether the transaction "gives" a security interest for the purpose of such laws. Other rules of law or the agreement of the parties determine the location of "title" for such purposes.

Petitions for reclamation brought by a secured party in his debtor's insolvency proceedings have often been granted or denied on a title theory: where the secured party has title, reclamation will be granted; where he has "merely a lien", reclamation

may be denied. For the treatment of such petitions under this Article, see Point 1 of Comment to Section 9—507.

Cross References:

Sections 2—401 and 2—507.

Definitional Cross References:

"Collateral". Section 9—105.

"Debtor". Section 9—105.

"Remedy". Section 1—201.

"Rights". Section 1—201.

"Secured party". Section 9—105.

12A:9-201. When Security Interest Attaches; After-Acquired Property; Future Advances.

(1) A security interest cannot attach until there is agreement (subsection (3) of 12A:1-201) that it attach and value is given and the debtor has rights in the collateral. It attaches as soon as all of the events in the preceding sentence have taken place unless explicit agreement postpones the time of attaching.

(2) For the purposes of this section the debtor has no rights

(a) in crops until they are planted or otherwise become growing crops, in the young of livestock until they are conceived;

(b) in fish until caught, in oil, gas or minerals until they are extracted, in timber until it is cut;

(c) in a contract right until the contract has been made;

(d) in an account until it comes into existence.

(3) Except as provided in subsection (4) a security agreement may provide that collateral, whenever acquired, shall secure all obligations covered by the security agreement.

(4) No security interest attaches under an after-acquired property clause

(a) to crops which become such more than one year after the security agreement is executed except that a security interest in crops which is given in conjunction with a lease or a land purchase or improvement transaction evidenced by a contract, mortgage or deed of trust may if so agreed attach to crops to be grown on the land concerned during the period of such real estate transaction;

(b) to consumer goods other than accessions (12A:9-314) when given as additional security unless the debtor acquires rights in them within ten days after the secured party gives value.

(5) Obligations covered by a security agreement may include future advances or other value whether or not the advances or value are given pursuant to commitment. L.1961, c. 120, § 9-201.

New Jersey Study Comment

1. § 9-204 states the general rule governing the time when a security interest attaches to collateral. Subsection (1) provides that unless there is an explicit agreement to postpone the time of attaching, then the security interest attaches when, and only when, there is a concurrence of three conditions: (a) an agreement [see, § 1-201(3)], (b) value is given, and (c) the debtor has an interest in the collateral. *This rule governs only the attachment, or acquisition of the security interest.* It does not state the rules as to perfection of the interest (once acquired) as against any person or class of persons or rules as to subordination or priority.

2. The requirement that there must be an agreement must be read *not only* in connection with § 1-201(3), but also in connection with § 9-203 which requires that the security agreement be written (see, Comments, § 9-203) unless the collateral is in the possession of the secured party. So much of § 9-204(1) as requires an "agreement" expressing an intent that a security interest be created makes no change in New Jersey law. See, *Commonwealth Finance Corp. v. Schutt*, 94 N.J.L. 225, 116 Atl. 722 (E. & A. 1922); *Dunham v. Cramer*, 63 N.J.Eq. 151 (Ch. 1902).

3. § 9-204(1) further requires that "value" be given. Value as used in this section is defined in § 1-201(44) and includes, *inter alia*, any consideration sufficient to support a simple contract. § 1-201(44) (d). An antecedent debt is value, although a security interest supported by an antecedent debt may be subject to defeat or subordination. See, §§ 9-108, 9-312(3) and (4). So much of § 9-204(1) as requires that value be given makes no change in New Jersey law. See *Collerd v. Tully*, 77 N.J.Eq. 439, 448, 77 Atl. 1079, 1082, *aff'd*, 78 N.J.Eq. 557, 80 Atl. 491 (E. & A. 1911). In the *Collerd* case the Chancery Court assumed that the consideration which would support a chattel mortgage had of necessity to be present consideration. The Court of Errors and Appeals ruled however that an antecedent debt satisfied the requirements of consideration. The Court expressly made the distinction now embodied in Article 9:

A distinction is to be made between the validity of a chattel mortgage given for a precedent debt, which is not questioned in our cases, and its right to priority, which might in some cases depend on whether it was required to be for a valuable consideration, as that term is used

12A:9-204 UNIFORM COMMERCIAL CODE

Ch. 9

in some of our registry acts.
80 Atl. at p. 492.

Similarly, no change is made in the law of New Jersey as it was previously expressed in regard to trust receipts. See, R.S. 46:35-1; cf. R.S. 46:35-2.

4. §§ 9-204(1) and 9-204(3) together state a general rule that a security interest in after-acquired property stands on the same footing as a security interest in which the debtor has present rights. This rule is in accord with present New Jersey law that a mortgage of after-acquired property is not *per se* void. The New Jersey rule derives from *Smithhurst v. Edmunds*, 14 N.J. Eq. 408 (Ch.1862) and *Lister v. Simpson*, 38 N.J.Eq. 438 (Ch. 1884), and has been followed after the adoption of the Chattel Mortgage Act. *Buvinger v. Evening Union Printing Co.*, 72 N.J.Eq. 321, 65 Atl. 482 (Ch.1907). In *Commercial Trust Co. v. Wertheim Coal & Coke Co.*, 88 N.J.Eq. 143, 102 Atl. 448 (Ch.1917), *aff'd*, *Commercial Trust Co. v. Drayton*, 90 N.J.Eq. 264, 105 Atl. 241 (E. & A. 1918) the mortgage instrument not only covered all chattels and book accounts then owned by the mortgagor, but also all after-acquired chattels and book accounts that should be substituted in the regular course of business for those existing at the date of the mortgage. The Court held that:

... the chattel mortgage was a lien as against creditors on book accounts that arose after the date of the mortgage and as to chattels acquired after the date of

the mortgage. 102 Atl. at 481.

5. § 9-204(4) expressly governs the attachment of security interests under an after-acquired property clause as to crops and consumer goods other than accessions: § 9-204(2) lays down four rules governing the debtor's acquisition of rights in four classes of property.

Clause (a) modifies the law of New Jersey to the extent that under § 9-204 the debtor has no right in crops until planted or in livestock until conceived. Under the Crop Mortgage Act the courts of New Jersey recognized a transferable interest of the debtor in crops not yet planted. See, *Stokely Bros. & Co., Inc. v. Conklin*, 131 N.J.Eq. 552, 26 A.2d 147 (Ch.1942).

The validity of a grant or mortgage of a farm crop to be grown, made by a tenant or owner of lands, has long been accepted. (Emphasis added.) *Id.* 26 A.2d at 149.

The Vice Chancellor in the *Conklin* case traced the rule back to the case of *Grantham v. Hawley*, Hob. 132, 80 Eng.Rep. 281 (1615). Under the modification introduced by § 9-204 the rights of the debtor to create a valid *present* security interest arises at the time of planting. No case has been found construing the Crop Mortgage Act, R.S. 4:18-2 as regards to livestock. It would appear however, that the present law of New Jersey is in accord with the construction expressed in the *Conklin* case, and, as such, will be similarly modified by § 9-204(2) (a).

Clause (b) of § 9-204(2) provides the debtor has no rights for purposes of creation of a present security interest in fish until caught, gas or minerals until extracted, or timber until cut. While specific cases involving fish, gas, minerals or unsevered timber (apart from realty mortgages) appear not to have arisen, the general rule in New Jersey has been clear that valid present security interests could be created in property to be acquired [after acquired property clauses]:

[A]s to after acquired property, the rule is that the mortgage will be held to extend to such property, if the court under the terms of the mortgage would have decreed a specific performance of a contract to sell or to pledge it. . . . Proof that he has acquired title is proof of the thing intended to be transferred. This clause [after acquired property], therefore, will not fail because of uncertainty. If it be held bad, it must be because the court finds that one cannot legally agree to pledge to another all of certain kinds of property to which he may in the future acquire title. I know of no such principle, and in fact, many of the decided cases show there is no such principle. *Collerd v. Tully*, 77 N.J.Eq. 439, 77 Atl. 1079, 1081 (Ch.1910).

Prior to 1948 a distinction had to be drawn between the validity of such mortgages (wherein the debtor had not yet acquired title) at law and in equity. To con-

stitute a valid mortgage *at law*, the mortgager had to have a present property, either actual or potential in the collateral. *Looker v. Peckwell*, 38 N.J.L. 253 (Sup.Ct.1876). The *Looker* case was not however followed, and the equity rule stated in the *Collerd* case was beyond doubt the law of New Jersey. See, also, *Commercial Trust Co. v. Drayton*, *supra*. After 1948, it was clear that the validity of the security interest would no longer be affected by the jurisdictional basis (law or equity) of the court that heard a particular case. The effect of § 9-204(2) (b) is, however, to reinstate the *Looker* rule as to fish, oil, gas, minerals or timber.

Clause (c) of § 9-204 provides that the debtor has no rights in a contract right until the contract is made. This clause makes no change in the law of New Jersey as it was settled in *Stokely Bros. & Co., Inc. v. Conklin*, *supra*: An assignment of a right expected to arise under a contract not in existence at the time of the assignment does not create a valid security interest in the assignee, but constitutes only a promise that when the money becomes due or the right becomes enforceable, that it will be transferred to the assignee.

Clause (d) of § 9-204 provides that the debtor has no rights in an account until the account comes into existence. This clause modifies the law of New Jersey as to accounts where there is an existing contract between the debtor-assignor and the obligor on the account. Under present New Jersey law such accounts to arise

in *futuro* may be subject to a valid present security interest. Commercial Trust Co. v. Drayton, *supra*; Gerard Trust Co. v. Standard Gas Co., 93 N.J.Eq. 307, 115 Atl. 910 (Ch.1922).

6. § 9-204(5) makes no change in the law of New Jersey.

See, *Schneider v. Schmidt*, 70 Atl. 688 (Ch.1908); *Higgins v. Schmidt*, 115 N.J.Eq. 64, 169 Atl. 522 (Ch.1903); R.S. 46:35-13 (b); R.S. 2A:44-179. § 9-204 (5) represents simply a special case of the general rule expressed in § 9-204(3).

Uniform Commercial Code Comment

Prior Uniform Statutory Provision: None.

Purposes:

1. Subsection (1) states three basic prerequisites to the existence of a security interest: agreement, value, and collateral. When these three coexist a security interest may, in the terminology adopted in this Article, attach. Perfection of a security interest will in many cases depend on the additional step of filing a financing statement (see Section 9-302); Section 9-301 states who will take priority over a security interest which has attached but which has not been perfected. The second sentence of the subsection states a rule of construction under which the security interest, unless postponed by explicit agreement, attaches automatically when the three stated events have occurred.

2. Subsections (1) and (3) read together make clear that a security interest arising by virtue of an after-acquired property clause has equal status with a security interest in collateral in which the debtor has rights at the time value is given under the security agreement. (To this general rule subsection (4)

states two exceptions.) That is to say: the security interest in after-acquired property is not merely an "equitable" interest; no further action by the secured party—such as the taking of a supplemental agreement covering the new collateral—is required. This does not however mean that the interest is proof against subordination or defeat: Section 9-108 should be consulted on when a security interest in after-acquired collateral is not security for antecedent debt, and Section 9-312(3) and (4) on when such a security interest may be subordinated to a conflicting purchase money security interest in the same collateral.

3. This Article accepts the principle of a "continuing general lien" which is stated in Section 45 of the New York Personal Property Law and other similar statutes applicable to "factor's lien". It rejects the doctrine—of which the judicial attitude toward after-acquired property interests was one expression—that there is reason to invalidate as a matter of law what has been variously called the floating charge, the free-handed mortgage and the lien on a shifting stock. This Article validates a

security interest in the debtor's existing and future assets, even though (see Section 9-205) the debtor has liberty to use or dispose of collateral without being required to account for proceeds or substitute new collateral. (See further, however, Section 9-306 on Proceeds and Comment thereto.)

The widespread nineteenth century prejudice against the floating charge was based on a feeling, often inarticulate in the opinions, that a commercial borrower should not be allowed to encumber all his assets present and future, and that the protection not only of the borrower but of his other creditors a cushion of free assets should be preserved. That inarticulate premise has much to recommend it. This Article decisively rejects it not on the ground that it was wrong in policy but on the ground that it has not been effective. In the past fifty years there has been a multiplication of security devices designed to avoid the policy: field warehousing, trust receipts, "factor's lien" acts and so on. The cushion of free assets has not been preserved. In almost every state it is now possible for the borrower to give a lien on everything he has or will have. There have no doubt been sufficient economic reasons for the change. This Article, in expressly validating the floating charge, merely recognizes an existing state of things. The substantive rules of law set forth in the balance of the Article are designed to achieve the protection of the debtor and the equitable resolu-

tion of the conflicting claims of creditors which the old rules no longer give.

4. Subsection (2) states the time at which debtor has rights in collateral in specified cases. A security agreement may be executed and value given before the debtor acquires rights: the security interest will then attach under subsection (1), as to after-acquired property, when he does. Subsection (2) states when that is in several controversial cases. Notice that the vexed question of assignment of future accounts is treated like any other case of after-acquired property: no periodic list of accounts is required by this Act. Where less than all accounts are assigned such a list may of course be necessary to permit identification of the particular accounts assigned.

5. Subsection (3) has been already referred to in connection with after-acquired property. It also serves to validate the so-called "cross-security" clause under which collateral acquired at any time may secure advances whenever made.

6. Subsection (4) (a) follows many state statutes which invalidate long-term security arrangements designed to cover future crops. Under existing statutes varying time limits are stated, the most frequent being one year, the period adopted by this section. The "except" clause permits a security interest in future crops in favor of a real estate lessor, mortgagee, conditional vendor or other encumbrancer during the continuance

of his interest in the realty—this provision, again, is in accord with many existing statutes. Note that the real estate transaction involved must be one of lease or purchase or improvement of the land. Section 9-312(2) should be consulted on the subordination of such an interest to a later interest arising from a current crop production loan.

7. Subsection (4) (b) limits the operation of the after-acquired property clause against consumers. No such interest can be claimed as additional security in consumer goods (defined in Section 9-109), except accessions (see Section 9-314), acquired more than ten days after the giving of value.

8. Under subsection (5) collateral may secure future as well as present advances when the security agreement so provides. At common law and under chattel mortgage statutes there seems to have been a vaguely articulated prejudice against future advance agreements comparable to the prejudice against after-acquired property interests. Although only a very few jurisdictions went to the length of invalidating interests claimed by virtue of future advances, judicial limitations severely restricted the usefulness of such arrangements. A common limitation was that an interest claimed in collateral existing at the time the security transaction was entered into for advances made thereafter was good only to the extent that the original security agreement specified the

amount of such later advances and even the times at which they should be made. In line with the policy of this Article toward after-acquired property interests this subsection validates the future advance interest, provided only that the obligation be covered by the security agreement. This is a special case of the more general provision of subsection (3).

As in the case of interests in after-acquired collateral, a security interest based on future advances may be subordinated to conflicting interests in the same collateral. See Section 9-312(3) and (4).

Cross References:

Point 1: Sections 9-301 and 9-302.

Point 2: Sections 9-108 and 9-312.

Point 3: Sections 9-205 and 9-306.

Point 4: Sections 9-110 and 9-203(1) (b).

Point 6: Section 9-312(2).

Point 7: Sections 9-109 and 9-314.

Point 8: Section 9-312(3) and (4).

Definitional Cross References:

"Account". Section 9-106.

"Agreement". Section 1-201.

"Collateral". Section 9-105.

"Consumer goods". Section 9-109.

"Contract". Section 1-201.

"Contract right". Section 9-106.

"Debtor". Section 9-105.

"Purchase". Section 1-201.

"Rights". Section 1-201.

"Secured party". Section 9-105.

"Security agreement". Section 9-105.

"Security interest". Section 1-201.

"Value". Section 1-201.

12A:9-303. When Security Interest Is Perfected; Continuity of Perfection.

(1) A security interest is perfected when it has attached and when all of the applicable steps required for perfection have been taken. Such steps are specified in 12A:9-302, 9-304, 9-305 and 9-306. If such steps are taken before the security interest attaches, it is perfected at the time when it attaches.

(2) If a security interest is originally perfected in any way permitted under this Chapter and is subsequently perfected in some other way under this Chapter, without an intermediate period when it was unperfected, the security interest shall be deemed to be perfected continuously for the purposes of this Chapter. L.1961, c. 120, § 9-303.

New Jersey Study Comment

1. Section 9-303 makes express the implication derived from §§ 9-204, 9-301, 9-302, 9-304, 9-305 and 9-306 that a security interest becomes perfected under Article 9 when the interest has attached (§ 9-204) and all steps required under §§ 9-301, 9-302, 9-304, 9-305 and 9-306 have been taken by the creditor. The concept of perfection as used in § 9-303 is derived from § 60 of the Bankruptcy Act which in substance provides that a security interest is perfected when it is no longer capable of being upset by a subsequent creditor or bona fide purchaser and not subject to defeasance in insolvency proceedings. It should be noted that even though a security interest may be perfected it may still be subordinated to some other interest as required by other sections of Article 9. Under present New Jersey law there is no express statement of a theory of perfection. Section 9-303, first two sentences, is generally in accord with the present theory of the New Jersey security statutes requiring a filing to protect the interest against subsequent defeasance. See, Chattel Mortgage Act, R.S. 46:28-5; Uniform Conditional Sales Act, R.S. 46:32-10; Factors' Lien Act, N.J. Stat. 2A:44-180 *et seq.* and Uniform Trust Receipts Act, R.S. 46:35-3 *et seq.* The third sentence of § 9-303(1) states that if the perfection steps are taken before the security interest attaches (as defined by § 9-204) it is perfected at the time of attachment. This statement restates the New Jersey law as it exists in regard

to after acquired property, i. e., a security interest which attaches under an after acquired property clause after filing becomes perfected without necessity of a further filing or a change of possession. *Commercial Trust Co. v. Wertheim Coal & Coke Co.*, 88 N.J. Eq. 143, 102 Alt. 448 (Ch.1917), *aff'd Commercial Trust Co. v. Drayton*, 90 N.J.Eq. 264, 105 Alt. 241 (E. & A.1918). In other cases a security interest acquired after filing must be perfected at or after acquisition of the interest. See, *Stokely Bros. & Co., Inc. v. Conklin*, 131 N.J.Eq. 552, 26 A.2d 147 (Ch.1942).

Again, however, it should be noted that the underlying analysis of a security interest under Article 9 depends upon the nature of the collateral and the purposes the security interest is to serve. Under present New Jersey law analysis of a security interest depends upon the particular security device employed. Consequently, each of particular sections of Article 9 stating special rules for perfection of the security interest (§§ 9-305, 9-306) will state new law in New Jersey.

2. Section 9-303(2) provides that a security interest perfected in any way permitted under Article 9 and is subsequently perfected in some other permitted way, the security interest is deemed continuously perfected if no intermediate unperfected period intervened between the two perfections. The following example is given in the Uniform Laws Comment:

2. The following example will illustrate the operation of subsection (2): A bank which has issued a letter of credit honors drafts drawn under the credit and receives possession of the negotiable bill of lading covering the goods shipped. Under Sections 9-304(2) and 9-305 the bank now has a perfected security interest in the document and the goods. The bank releases the bill of lading to the debtor for the purpose of procuring the goods from the carrier and selling them. Under Section 9-304 (5) the bank continues to have a perfected security in-

terest in the document and goods for 21 days. The bank files before the expiration of the 21-day period. Its security interest now continues perfected for as long as the filing is good. The goods are sold by the debtor. The bank continues to have a security interest in the proceeds of sale to the extent stated in Section 9-306(3).

There is no present counterpart in New Jersey statutes to § 9-303 (2). There is no reason, however, to believe that under present law a result inconsistent with clause (2) would be reached.

Uniform Commercial Code Comment

Prior Uniform Statutory Provision: None.

Purposes:

1. The term "attach" is used in this Article to describe the point at which property becomes subject to a security interest. The requisites for attachment are stated in Section 9-204. When it attaches a security interest may be either perfected or unperfected: "Perfected" means that the secured party has taken all the steps required by this Article as specified in the several sections listed in subsection (1). A perfected security interest may still be or become subordinate to other interests (see Section 9-312) but in general after perfection the secured party is protected against creditors and transferees of the debtor and in particular against any representative of creditors in in-

solveny proceedings instituted by or against the debtor. Subsection (1) states the truism that the time of perfection is when the security interest has attached and any necessary steps for perfection (such as taking possession or filing) have been taken. If the steps for perfection have been taken in advance (as when the secured party files a financing statement before giving value or before the debtor acquires rights in the collateral), then the interest is perfected automatically when it attaches.

2. The following example will illustrate the operation of subsection (2): A bank which has issued a letter of credit honors drafts drawn under the credit and receives possession of the negotiable bill of lading covering the goods shipped. Under

Sections 9-304(2) and 9-305 the bank now has a perfected security interest in the document and the goods. The bank releases the bill of lading to the debtor for the purpose of procuring the goods from the carrier and selling them. Under Section 9-304(5) the bank continues to have a perfected security interest in the document and goods for 21 days. The bank files before the expiration of the 21 day period. Its security interest now continues perfected for as long as the filing is good. The goods are sold by the debtor. The bank continues to have a security interest in the proceeds of sale to the extent stated in Section 9-306(3).

If the successive stages of the bank's security interest succeed each other without an intervening gap, the security interest is "continuously perfected" and the date of perfection is when the interest first became perfected (i. e., in the example given, when the bank received possession of the bill of lading against honor of the drafts). If, however, there is a gap between stages—for example, if the bank does not file until after the ex-

piration of the 21 day period specified in Section 9-304(5), the collateral still being in the debtor's possession—then, the chain being broken, the perfection is no longer continuous. The date of perfection would now be the date of filing (after expiration of the 21 day period); the bank's interest might now become subject to attack under Section 60 of the Federal Bankruptcy Act and would be subject to any interests arising during the gap period which under Section 9-301 take priority over an unperfected security interest.

The rule of subsection (2) would also apply to the case of collateral brought into this state subject to a security interest which became perfected in another state or jurisdiction. See Section 9-103(3).

Cross References:

Sections 9-302, 9-304, 9-305 and 9-306.

Point 1: Sections 9-204 and 9-312.

Point 2: Sections 9-103(3) and 9-301.

Definitional Cross Reference:

"Security interest". Section 1-201.

12A:9-305. When Possession by Secured Party Perfects Security Interest Without Filing.

A security interest in letters of credit and advices of credit (subsection (2) (a) of 12A:5-116), goods, instruments, negotiable documents or chattel paper may be perfected by the secured party's taking possession of the collateral. If such collateral other than goods covered by a negotiable document is held by a bailee, the secured party is deemed to have possession from the time the bailee receives notification of the secured party's interest. A security interest is perfected by possession from the time possession is taken without relation back and continues only so long as possession is retained, unless otherwise specified in this Chapter. The security interest may be otherwise perfected as provided in this Chapter before or after the period of possession by the secured party. L.1961, c. 120, § 9-305.

New Jersey Study Comment

1. Section 9-305 restates the common-law rule of security that a secured party may perfect a security interest by taking possession of the collateral. For example, a pledge transaction is perfected by the pledgee's possession of collateral. *Mill Factors Corp. v. Guardian Trust Co.*, 107 N.J.L. 529, 154 Atl. 420 (E. & A. 1931).

Under the Chattel Mortgage Act, possession of the collateral in the secured party is an alternative method to filing for perfection of the security interest. Consequently, the policy expressed by § 9-305 does not introduce a novel concept into New Jersey law. The rule stated in § 9-305 is applicable, however, only to letters of credit and advices of credit [see § 5-116 on assignments of letters and advices of credit] goods, instruments, negotiable documents or chattel paper. The intent of the section is to exclude accounts, contract rights and general intangibles from the rule which allows perfection by possession. Security interests in the latter type of property may be perfected only by filing. See, § 9-302. The possession required for perfection may be by the secured party or an agent for the secured

party. Neither this section nor § 9-205 is intended to permit the debtor himself to qualify as the agent of the secured party for purposes of satisfying a requirement that possession be in the secured party. As to this point, no change in New Jersey law is contemplated. See, *Dirigo Tool Co. v. Woodruff*, 41 N.J.Eq. 336, 7 Atl. 125 (1886) for establishment of this rule.

2. Section 9-305 also adopts the theory of the Chandler Amendments to § 60 of the Bankruptcy Act which reject the theory of relation back of equitable pledges. Under the "relation back" doctrine a security agreement might be entered into by the secured party and the debtor. Sometime thereafter if the secured party took possession of the collateral, the original security agreement was deemed perfected as of its date by virtue of the subsequent possession. See, *Sexton v. Kessler & Co.*, 225 U.S. 90 (1912). Section 9-305 expressly rejects the equitable pledge relation back theory in the third sentence of the section. The only exception to the rule of the third sentence of § 9-305 is the 21 day relation back period provided in § 9-304(4) and (5).

Uniform Commercial Code Comment

Prior Uniform Statutory Provision: None.

Purposes:

1. As under the common law of pledge, no filing is required by this Article to perfect a security interest where the secured party has possession of the collateral. Compare Section 9-302(1) (a). This Section permits a security interest to be perfected by transfer of possession only when the collateral is goods, instruments, documents or chattel paper: that is to say, accounts, contract rights and general intangibles are excluded. See Section 5-116 for the special case of assignments of letters and advices of credit. A security interest in accounts, contract rights and general intangibles—property not ordinarily represented by any writing whose delivery operates to transfer the claim—may under this Article be perfected only by filing, and this rule would not be affected by the fact that a security agreement or other writing described the assignment of such collateral as a “pledge”. Section 9-302(1) (e) exempts from filing certain assignments of accounts or contract rights which are out of the ordinary course of financing: such exempted assignments are perfected when they attach under Section 9-303 (1); they do not fall within this Section.

2. Possession may be by the secured party himself or by an agent on his behalf: it is of

then provided in Section 9-304 (4) and (5), during which a debtor may have possession of specified collateral in which there is a perfected security interest.

Cross References:

Sections 5-116, 9-204, 9-302, 9-303 and 9-304.

Definitional Cross References:

“Chattel paper”. Section 9-105.

course clear, however, that the debtor or a person controlled by him cannot qualify as such an agent for the secured party. See also the last sentence of Section 9-205. Where the collateral (except for goods covered by a negotiable document) is held by a bailee, the time of perfection of the security interest, under the second sentence of the Section, is when the bailee receives notification of the secured party's interest: this rule rejects the common law doctrine that it is necessary for the bailee to attorn to the secured party or acknowledge that he now holds on his behalf.

3. The third sentence of the Section rejects the “equitable pledge” theory of relation back, under which the taking possession was deemed to relate back to the date of the original security agreement. The relation back theory has had little vitality since the 1938 revision of the Federal Bankruptcy Act, which introduced in Section 60(a) provisions designed to make such interests voidable as preferences in bankruptcy proceedings. This Section now brings state law into conformity with the overriding federal policy: where a pledge transaction is contemplated, perfection dates only from the time possession is taken, although a security interest may attach, unperfected, before that under the rules stated in Section 9-204. The only exception to this rule is the short twenty-one day period of perfec-

“Collateral”. Section 9-105.

“Documents”. Section 9-105.

“Goods”. Section 9-105.

“Instruments”. Section 9-105.

“Receives notification”. Section 1-201.

“Secured party”. Section 9-105.

“Security interest”. Section 1-201.

Ch. 9 SECURED TRANSACTIONS, ETC. 12A:9-306

12A:9-306. "Proceeds"; Secured Party's Rights on Disposition of Collateral.

(1) "Proceeds" includes whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of. The term also includes the account arising when the right to payment is earned under a contract right. Money, checks and the like are "cash proceeds". All other proceeds are "non-cash proceeds".

(2) Except where this Chapter otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof by the debtor unless his action was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

(3) The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a perfected security interest and becomes unperfected ten days after receipt of the proceeds by the debtor unless:

(a) a filed financing statement covering the original collateral also covers proceeds; or

(b) the security interest in the proceeds is perfected before the expiration of the ten day period.

(4) In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest

(a) in identifiable non-cash proceeds;

(b) in identifiable cash proceeds in the form of money which is not commingled with other money or deposited in a bank account prior to the insolvency proceedings;

(c) in identifiable cash proceeds in the form of checks and the like which are not deposited in a bank account prior to the insolvency proceedings; and

(d) in all cash and bank accounts of the debtor, if other cash proceeds have been commingled or deposited in a bank account, but the perfected security interest under this paragraph (d) is

(i) subject to any right of set-off; and

(ii) limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings and commingled or deposited in a bank

account prior to the insolvency proceedings less the amount of cash proceeds received by the debtor and paid over to the secured party during the ten day period.

(5) If a sale of goods results in an account or chattel paper which is transferred by the seller to a secured party, and if the goods are returned to or are repossessed by the seller or the secured party, the following rules determine priorities:

- (a) If the goods were collateral at the time of sale for an indebtedness of the seller which is still unpaid, the original security interest attaches again to the goods and continues as a perfected security interest if it was perfected at the time when the goods were sold. If the security interest was originally perfected by a filing which is still effective, nothing further is required to continue the perfected status; in any other case, the secured party must take possession of the returned or repossessed goods or must file.
- (b) An unpaid transferee of the chattel paper has a security interest in the goods against the transferor. Such security interest is prior to a security interest asserted under paragraph (a) to the extent that the transferee of the chattel paper was entitled to priority under 12A:9-308.
- (c) An unpaid transferee of the account has a security interest in the goods against the transferor. Such security interest is subordinate to a security interest asserted under paragraph (a).
- (d) A security interest of an unpaid transferee asserted under paragraph (b) or (c) must be perfected for protection against creditors of the transferor and purchasers of the returned or repossessed goods.

L.1961, c. 120, § 9-306.

New Jersey Study Comment

1. The purpose of this section is to state the secured party's right to the proceeds of an unauthorized disposition by the debtor of the collateral. Section 9-306 (1) defines proceeds, cash proceeds and non-cash proceeds. It should be noted that the term proceeds includes accounts arising

where the debtor's right to payment is earned under a contract right.

2. Section 9-306(2) restates the rule under existing New Jersey law that when the debtor makes an unauthorized disposition of the collateral, the security in-

terest in the collateral continues since the transferee of the collateral takes subject to the perfected security interest. This is, of course, the effect of the present security legislation in New Jersey that a perfected security interest is good against subsequent creditors, bona fide purchasers and mortgagees in good faith. Thus, the first clause of § 9-306(2) makes no change in the present theory of New Jersey law. It should be noted, however, that the Code makes express provision for subordination (in certain instances) of perfected security transactions.

The last clause of § 9-306(2) provides that the security interest also continues in any traceable proceeds including collections received by the debtor. The clause adopts the theory expressed in R. S. 46:35-10(c) as to Trust Receipts under present New Jersey law:

Where, under the terms of the trust receipt transaction, the trustee has no liberty of sale or other disposition, . . . the entruster shall be entitled . . .

(c) to any other proceeds of the goods, documents or instruments which are identifiable, unless provision for accounting has been waived by the entruster by words or conduct; . . .

See, Entruster's Right to Proceeds of Sale Under § 10 of the Uniform Trust Receipts Act, 66 Yale L.J. 922 (1957). New Jersey case authority on secured party's right to proceeds is meager. It has been held, however, that a mortgagee

has an equitable lien on the proceeds of sale of collateral covered by a chattel mortgage by an assignee of the mortgagor who assigns for the benefit of creditors. *Wilson v. Gray*, 10 N.J.Eq. 323 (Ch.1855). To the extent that the Gray case rests on the proposition that the assignee for the benefit of creditors stands in the shoes of the assignor-mortgagor in regard to the mortgagee, the rule would be carried forward by the last clause of § 9-306(2).

3. Section 9-306(3) provides that the security interest in the proceeds continues for a period of ten days. The security interest in the proceeds may continue beyond the ten days, if either of the alternative conditions in sub-clause (a) or (b) is met. Sub-clause (a) continues the security interest in proceeds, if a filed financial statement covering the original proceeds also covered the proceeds. Thus, it is apparent that in order to secure the continued perfection under sub-clause (a) the original security interest must have been perfected by a filing and that a perfection of the security interest other than by filing will not suffice to qualify the security interest under sub-clause (a). Sub-clause (b) permits, however, the perfection of the security interest in the proceeds *ab initio* within the ten day period specified by the main clause of § 9-306(3). The general scheme of R.S. 46:35-10 [Uniform Trust Receipts Act] is adopted in § 9-306(3) as well as in § 9-306(2).

4. The wording of both § 9-306(2) and (3) in terms of the continuance of an interest makes

clear that the security interest dates from perfection of the security interest in the original collateral. Thus, under § 60 of the Bankruptcy Act the four-month period specified therein would date from the original perfection in the collateral and not from the date whereon the proceeds arose. This theory of § 9-306(2) and (3) is contrary to the theory adopted in New Jersey that collateral and the cash proceeds thereof are separate properties and not merely the same property in two forms. The separate property theory was announced in *In re Payment of Unclaimed Deposits* (Engel), 45 N.J. Super. 327, 132 A.2d 540 (App. Div. 1957). It is arguable, however, that the Engel case represents a special situation and does not represent the general law of New Jersey. See, *Ferguson, Creditors' Rights*, 12 Rutgers L.Rev. 212, 214 (1957).

5. Section 9-306(4) (a), (b) and (c) provide that in the event of insolvency proceedings against the debtor, a secured party's security interest continues in traceable cash or non-cash proceeds. In the case of money, sub-section (b) limits the security interest to such money as is not commingled or deposited in a bank prior to the insolvency proceedings. Sub-section (c) limits the security interest in the case of checks, to checks not deposited in a bank prior to the insolvency proceedings. Sub-section (d) provides that where there has been either a commingling or a deposit in a bank account, the perfected security interest still continues but is subject to any right of set-off and is limited to an amount not greater than the

amount of any cash proceeds received by the debtor within ten days before institution of the insolvency proceedings less any proceeds paid to the secured party by the debtor within the ten day period. Section 9-306(4) (d) represents a departure in security law by recognizing a right in the secured party to non-traceable proceeds. Cf. *Wilson v. Gray*, 10 N.J. Eq. 323 (Ch. 1855) which assumes that traceability of the proceeds is a necessary precondition to the imposition of an equitable lien on proceeds. Section 9-306(4) (d) continues a security interest in non-traceable proceeds subject only to the limitations specified in sub-clause (4) (d) (i) and (ii).

6. Section 9-306(5) establishes priorities where a sale of goods results in an account receivable or chattel paper which is transferred by the seller to a secured party as collateral and the goods are returned or repossessed by the seller or secured party. Since, under present New Jersey law, the doctrine of *Benedict v. Ratner* is rejected, the secured party would retain his security interest even if the debtor failed to segregate returned goods. See, *Study Comments* § 9-205 *supra*. Under § 9-306(5) the priority of the secured party is determined according to sub-sections (a) through (d) of § 9-306(5). Sub-section (a) reinforces the rule of § 9-205 abrogating the *Benedict v. Ratner* doctrine. Thus, where goods are returned to the debtor the creditor's security interest re-attaches to the returned collateral as a perfected security interest without any further act on the part of the secured party. Since

Benedict v. Ratner was never a part of the law of New Jersey (see, *Comments*, § 9-205) sub-section (a) makes no change in New Jersey law.

Sub-section (b) provides that to the extent the transferee of the chattel paper is entitled to a priority under § 9-308, such priority overrides the security interest recognized under sub-section (a). Sub-section (c) provides that an unpaid transferee of the account receivable is subordinate to the security interest recognized in sub-section (a). The unpaid transferee claiming under sub-sections (b) or (c) must perfect a security

interest in the goods to protect himself against subsequent creditors of the transferor or purchasers of the goods. Thus, it is apparent that whereas the secured party who originally finances the debtor retains his security interest in goods upon return, transferee claimants under (b) and (c) are required to perfect their security interest in order to assert a claim against the returned goods prior to creditors of the transferor-debtor or buyers of the repossessed goods. The priority rules of § 9-306(5) (b) through (d) represent new law in New Jersey.

Uniform Commercial Code Comment

Prior Uniform Statutory Provision: Section 10, Uniform Trust Receipts Act.

Changes: Modified and rewritten.

Purposes of Changes:

1. To state a secured party's right to the proceeds received by a debtor on disposition of collateral and to state when his interest in such proceeds is perfected.

2. Changes from Prior Law:

(a) Whether a debtor's sale of collateral was authorized or unauthorized, prior law generally gave the secured party a claim to the proceeds. Sometimes it was said that the security interest attached to the "property" received in substitution; sometimes it was said the debtor sold the proceeds as "trustee" or "agent" for the secured party. Whatever the formulation of the

rule, the secured party, if he could trace the proceeds, could reclaim them or their equivalent from the debtor or his trustee in bankruptcy. The change in existing law made by this Section relates to non-identifiable cash proceeds; the secured party has, under conditions stated in sub-section (4) (d), a security interest in the debtor's cash and bank accounts equal to the amount of cash proceeds received and commingled or deposited within the 10 days before insolvency proceedings were instituted less the amount of cash proceeds received by the debtor and paid over to the secured party during that period, without regard to whether or not the funds are identifiable as cash proceeds of the collateral.

(b) Subsections (2) and (3) make clear that the four-month period for calculating a voida-

ble preference in bankruptcy begins with the date of the secured party's obtaining the security interest in the original collateral and not with the date of his obtaining control of the proceeds. The interest in the proceeds "continues" as a perfected interest if the original interest was perfected; but the interest ceases to be perfected after the expiration of ten days unless the financing statement covering the original collateral covered the proceeds or unless the secured party perfects his interest in the proceeds themselves—i. e., by filing a financing statement covering them or by taking possession.

(c) Where cash proceeds are covered into the debtor's checking account and paid out in the operation of the debtor's business, recipients of the funds of course take free of any claim which the secured party may have in them as proceeds. What has been said relates to payments and transfers in ordinary course. The law of fraudulent conveyances would no doubt in appropriate cases support recovery of proceeds by a secured party from a transferee out of ordinary course or otherwise in collusion with the debtor to defraud the secured party.

3. In most cases when a debtor makes an unauthorized disposition of collateral, the security interest, under prior law and under this Article, continues in the original collateral in the hands of the purchaser or other transferee. That is to say, since the transferee takes subject to the security interest, the secured

party may repossess the collateral from him or in an appropriate case maintain an action for conversion. Subsection (2) codifies this rule. The secured party may claim both proceeds and collateral, but may of course have only one satisfaction.

In many cases a purchaser or other transferee of collateral will take free of a security interest: in such cases the secured party's only right will be to proceeds. The transferee will take free whenever the disposition was authorized; the authorization may be contained in the security agreement or otherwise given. A claim to proceeds in a filed financing statement might be considered as impliedly authorizing sale or other disposition of the collateral, depending upon the circumstances of the parties, the nature of the collateral, the course of dealing of the parties and the usage of trade (see Section 1-205). Section 9-301 states when transferees take free of unperfected security interests. Sections 9-307 on goods, 9-308 on chattel paper and non-negotiable instruments and 9-309 on negotiable instruments, negotiable documents and securities state when purchasers of such collateral take free of a security interest even though perfected and even though the disposition was not authorized.

4. Subsection (5) states rules to determine priorities when collateral which has been sold is returned to the debtor: for example goods returned to a department store by a dissatisfied customer. The most typical

problems involve sale and return of inventory, but the subsection can also apply to equipment. Under the rule of *Benedict v. Ratner*, failure to segregate such returned goods sometimes led to invalidation of the entire security arrangement. This Article rejects the *Benedict v. Ratner* line of cases (see Section 9-205 and Comment). Subsection (5) (a) of this Section reinforces the rule of Section 9-205: as between secured party and debtor (and debtor's trustee in bankruptcy) the original security interest continues on the returned goods. Whether or not the security interest in the returned goods is perfected depends upon factors stated in the text.

Subsections (5) (b), (c) and (d) deal with a different aspect of the returned goods situation. Assume that a dealer has sold an automobile and transferred the chattel paper or the account arising on the sale to Bank X (which had not previously financed the car as inventory). Thereafter the buyer of the automobile rightfully rescinds the sale, say for breach of warranty, and the car is returned to the dealer. Subsection (5) (b) gives the bank as transferee of the chattel paper or the account a security interest in the car against the dealer. For protection against the dealer's creditors or purchasers from him (other than buyers in the ordinary course of business, see Section 9-307), Bank X as the transferee, under subsection (5) (d), must perfect its interest by taking possession of the car or by filing as to it. Perfection of

his original interest in the chattel paper or the account does not automatically carry over to the returned car, as it does under subsection (5) (a) where the secured party originally financed the dealer's inventory.

In the situation covered by (5) (b) and (5) (c) a secured party who financed the inventory and a secured party to whom the chattel paper or the account was transferred may both claim the returned goods—the inventory financier under subsection (5) (a), the transferee under subsections (5) (b) and (5) (c). With respect to chattel paper, Section 9-308 regulates the priorities. With respect to an account, subsection (5) (c) subordinates the security interest of the transferee of the account to that of the inventory financier. However, if the inventory security interest was unperfected, the transferee's interest could become entitled to priority under the rules stated in Section 9-312(5).

In cases of repossession by the dealer and also in cases where the chattel was returned to the dealer by the voluntary act of the account debtor, the dealer's position may be that of a mere custodian; he may be an agent for resale, but without any other obligation to the holder of the chattel paper; he may be obligated to repurchase the chattel, the chattel paper or the account from the secured party or to hold it as collateral for a loan secured by a transfer of the chattel paper or the account.

12A:9-306 UNIFORM COMMERCIAL CODE

Ch. 9

If the dealer thereafter sells the chattel to a buyer in ordinary course of business in any of the foregoing cases, the buyer is fully protected under Section 2-403(2) as well as under Section 9-307(1), whichever is technically applicable.

Cross References:

Sections 9-307, 9-308 and 9-309.

Point 3: Sections 1-205 and 9-301.

Point 4: Sections 2-403(2), 9-205 and 9-312.

Definitional Cross References:

"Account". Section 9-106.

"Bank". Section 1-201.

"Chattel paper". Section 9-105.

"Check". Sections 3-104 and 9-105.

"Collateral". Section 9-105.

"Contract right". Section 9-106.

"Creditors". Section 1-201.

"Debtor". Section 9-105.

"Goods". Section 9-105.

"Insolvency proceedings".

Section 1-201.

"Money". Section 1-201.

"Purchaser". Section 1-201.

"Sale". Sections 2-106 and 9-105.

"Secured party". Section 9-105.

"Security agreement". Section 9-105.

"Security interest". Section 1-201.

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